Responsible Lending in Latvian Banks

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ABSTRACT

Irresponsible borrowing promoted financial crisis not only in Latvia but also in the rest of the world. After the beginning of the crisis the government and other responsible institutions realized the necessity to promote responsible lending and borrowing.

The aim of this article is to clarify basic principles of responsible lending in lending agreements between banks and individuals in Latvia, as well as in the existing legislation that regulates this process.

In order to obtain research results the authors conducted qualitative analysis of scientific literature on the issues of responsible lending; legislation that regulates mortgage lending in Latvia; successful experience of banks in other countries, such as Westpac Group, Bank of America and Bank of Lithuania; information available on home pages of banks about commercial bank loan volumes for mortgage loans with different types of real estate asset backing; information included in loan agreements of four commercial banks and its compliance with the laws and regulations. Loan borrower evaluation stages for review of a new loan application were developed. On the basis of loan agreement analysis the authors elaborated a formula of monthly loan payments in occurrence of unfavourable period for the client of the bank.

As a result of the research authors came to a conclusion that in Latvia there is no legislation that directly regulates mortgage loans. Hence, in the author's opinion, in order to promote responsible lending and borrowing in Latvia similarly as in Lithuania laws and regulations should be developed that would regulate the maximum possible amount of the loan depending on the market or purchase value of the real estate thus also levelling off the competition between local commercial banks and affiliations of foreign banks in Latvia.

During the research the authors also faced some restrictions, as not all banks in Latvia, which continue lending activities, are willing to give information included in loan agreements.

The research conducted by authors will be significant not only for the banks analyzed in this article, but also for borrowers, allowing them to make objective appraisal of loan agreement terms of each bank.

Keywords: Responsible lending, laws and regulations, agreements, loans, banks, Latvia.

1. INTRODUCTION

Banks play the main role in financing of entrepreneurship and services in all sectors of the national economy, thus it is essential for bank analysts to evaluate solvency of customers by reviewing new loan transactions and thus avoiding unforseen expenses that might occur as a result of irresponsible financing of loan transactions and in such a way maximally decreasing both social and financial risks.

The issue of responsible lending came into focus of attention and started to get solved upon the onset of financial crisis that caused consumer distrust towards the bank sector as such, thus unambiguously resulting also in higher payment for products and services offered by banks. One more important factor is that loans play an important role in all national economies; it was clearly seen in Latvia as well, creating opportunity for entrepreneurs to purchase new and modern manufacturing equipment in the pre-crisis period, thus increasing competitiveness. It was also confirmed by the statement of the European Commissioner for Internal Market and Services Charlie McCreevy "The financial crisis has shown the damage that irresponsible lending and borrowing practices can have on consumers, lenders, the financial system and the economy at large" [1].

Many banks in the world and also in Latvia carried out aggressive market drives by dumping loan interest rates in relation to their competitors, thus disregarding human capital and its significance. Already in 2006 Watchman et al. mentioned that creditors should change their aggressive loan policy to a new one that would be based on environmental issues, sustainable development and human resources, in such a way directing banks towards responsible lending [2]. Whereas the Centre for Responsible Lending mention consequences in the real estate market that led to its stagnation as the main problem of irresponsible lending [3].

There are both positive and negative points in such comparison. On the positive side there is the fact that Latvia is a small country and the scale is not comparable, for example, with Germany, but rather comparable with Montenegro. The U.S.A. banking sector operates on a completely different scale. The total assets of 416 problem American banks at the end of June 2009 amounted to 299.8 billion dollars [4].

The negative point is that the current level of aggregate capital of Latvian banks does not meet the requirements of economic growth and does not allow the bank lending system to deploy the real sector of economy. The problem of capitalization of the Latvian banks increased as their lending was exacerbated by the growth of bad loans.

The purpose of the research is to find out how the basic principles of responsible lending in lending agreements between banks and individuals in Latvia are considered, as well as to study the existing legislation that regulates this process.

The object of the research is responsible lending in Latvia.

To achieve the goal the following research methods were used: quantitative and qualitative methods, including the method of sociologic research and the descriptive method.

2. LITERATURE REVIEW

With the beginning of the financial crisis, in the scientific literature great attention was paid to responsibility of banks for credit products they offer, especially making topical the issue of responsible lending. So what is responsible lending? There is no unambiguous answer to this question in the scientific literature, it mentions only that it is regulated by directives that specify information to be included in loan agreements and that the creditor has to evaluate the borrower's solvency to meet their liabilities in present and in future.

Already in 2005 Hutchings in his research mentioned that banks do not perceive their mutual competition as an advantage but rather their ability to develop responsibility for services offered by banks [5]. Whereas Bricker et al emphasized that responsible lending is also based on asset creation that includes also total assets of households [6]. In other literature sources it is stated that responsible lending is not based only on financial factors but also on environmental factors that includes also sustainable development [7].

Banks not only in the European Union but also in the entire world more and more often put forward responsible lending as one of the prerequisites for successful development. It has been also stated by Bank of Montreal Financial Group that banks focus on responsible lending practice and development strategy, thus ensuring effective decision making [8]. For example, also in Latvia's neighbouring country's Bank of Lithuania the principles of responsible lending are being implemented, they are based on loan value ratios, risk management, as well as elaboration of rules that is based on domestic financial system's resilience against problems of market imbalance [9].

According to Australian Securities and Investment Commission credit licensees are liable also for responsible lending, as it is stated in Ch 3 of the National Consumer Credit Protection Act 2009 [10]. The main concept of this act is that consumer does not have to sign a loan agreement if it does not suit him/her. At the same time, European Commission in accordance with the statement of President of the European Council 2009-COM (2009) 114, undertook to come forward with measures at EU level on responsible lending and borrowing, including a reliable framework on credit intermediation, in the context of delivering responsible and reliable markets for the future and restoring consumer confidence [11].

In the White Paper on the Integration of EU Mortgage Credit Markets it is defined what exactly refers to responsible lending and borrowing, including pre-contract information, consultation, evaluation of solvency, early repayment and credit intermediation [12]. For example, according to 2007 data, in 27 European Union countries proportion of unpaid mortgage credits was 50.1% of European Union GDP, which in some member countries such as Spain, Ireland, Great Britain, Latvia and Lithuania sharpened the consequences of EU financial crisis [11].

2.1. Bank System in Latvia

The bank system in Latvia developed rapidly after Latvia regained its independence. During the first four years from 1991 till 1994 67 banks received licences. Although the total volume of actives in the bank system tripled in years 1992-1994, only 47 out of 55 licensed banks at the end of 1994 were able to submit annual report in the set time limits and only 16 of them finished the year with profit.

There are several reasons why Latvia had to go through the bank crisis. The bank sector developed too fast and much faster than economic environment, in which this sector operated. Real estate and securities markets were not sufficiently developed to provide liquid asset backing for granted loans. Due to lack of experience bankers and entrepreneurs made mistakes in crediting and in evaluation of business plans [13].

Since June 30, 2010 Latvia holds possession of three banks – the newly established bank JSC "Citadele banka" that was separated from JSC "Parex banka" that now performs the functions of the settlement bank and State JSC "Latvian Mortgage and Land Bank" that performs also functions of the development bank (at the end of September 2009 its equity capital was 6.1% of bank's paid-up capital). With the decision of the government of the Republic of Latvia on February 27, 2009 85.14% of the state-owned shares of JSC "Parex banka" were transferred to the State JSC "Privatization Agency". At the end of September 2009 JSC "Parex banka" equity capital was 16.1% of bank's paid in capital [14].

As shown by the Association of Commercial Banks of Latvia (ACBL) data for the 4th quarter of 2011, Latvian banking services are provided by 22 banks and 9 foreign bank branches, the European Economic Area countries also established credit institutions or their branches, which submitted the application to the FCMC, the with one bank - "VEF Banka" from 26.05.2010. License has been suspended and JSC "Latvijas Krājbanka" filed bankruptcy [15].

2.2. Laws and Regulations Regulating Responsible Lending in Latvia

Concerning the issue of responsible lending in the European Union on March 31, 2011 the European Commission issued the final version of the Directive of the European Parliament and Council COM (2011) 142 – 2011/0062 (COD) on Credit Agreements Relating to Residential Property [16]. This directive refers to the European Union member countries. It should be noted that several member states apply separate Directive 2008/48/EK of the European Parliament and of the Council of 23 April 2008 on Credit Agreements for Consumers for mortgage credits. The directive mentioned before refers to consumer credits from EUR 200 to EUR 75,000. The basic purpose of directive 2008/48/EK is to regulate promotional information, pre-contract information, information that should be included in the agreement, evaluation of solvency, proper explanations and demand for information disclosure with credit intermediation. The same directive refers to credits for purchasing real estate with a security of mortgage or collateral equated to it, or loans for reconstruction of the housing [17].

In Latvia consumer protection is regulated by a range of legislative acts that refer to both credits granted by banks and non-bank financial institutions: Law on Protection of Consumer Rights [18], Civil Law [19], and Cabinet Regulation No.1219 adopted on 28 December 2010 Regulations on Consumer Credit that came into force on 1 May 2011 [20], European Union Directive 2008/48/EK [17].

Mortgage borrowers in Latvia are protected by Law on Protection of Consumer Rights, edition as of 01.11.2011. that came into force on 22 June 2011.

Section 8 of this Law sets special provisions with respect to loans for which repayment is backed with an real estate mortgage. The most essential terms for such loans:

1. Section 8, Clause 1 – a grantor of credit is not entitled to request from a consumer who has not made any significant violation of the contract:

Subclause 1 – additional security of the granted credit on the basis of reduction of the value of immovable property in the credit security due to the changes in the immovable property market;

Subclause 2 – any costs for revaluation of mortgage credit security during the term of the contract;

Subclause 3 – the pre-term repayment of the credit granted.

2. Section 8, Clause 2 – if a consumer who has not committed any significant violation of the contract asks to do it, the grantor of credit has the duty to examine the proposal of the consumer

regarding extension of the period of time for credit repayment or change of the currency of the credit. In case of refusal the grantor of credit shall, within 30 days, issue a motivated reply to the consumer.
3. Section 8, Clause 3 – The changes in contract provisions referred to in Paragraph two of this Section may not be less favourable for a consumer in comparison with the existing market conditions at the time when the changes to be made in the contract are offered. The consumer is entitled to request the making of changes referred to in Paragraph two of this Section not less than once a year. The grantor of credit is not entitled to request any compensation for making of such changes, except a justified and reasonable payment for administrative expenditures of the service.
4. Section 8, Clause 4 – significant violation of the contract shall be considered:
Subclause 1 – delay of repayment of credit or interest payment for more than 60 days or more than three times a year for more than 30 days each time;
Subclause 2 – the use of credit for the purpose other than specified in the contract [18].
The other law that partly regulates mortgage lending is Cabinet Regulation No.1219 adopted on 28 December 2010, Regulations on Consumer Credit [20]. These regulations are based on suggestions of Directive 2008/48/EK of the European Parliament and the Council of 23 April 2008. Cabinet Regulation No.1219 covers issues that define calculation of annual interest rates; requirements for advertisement of crediting services; information that must be given to consumer before signing the credit agreement; information that should be included in crediting agreement (type of credit, creditor, agreement term, sum and terms of settlement, interest on delayed payments, consequences of default on payment); consumer notification; advanced repayment of credit.

3. METHODOLOGY

In the research part the authors analyzed responsible lending credit agreements for mortgage credits for private individuals.
To obtain results the authors performed qualitative analysis; reflection on bank credit changes from 2006 to March 2012; the summary of the volume of crediting loans on the basis of different types of mortgage loan securities (apartment, house, land); as well as on the basis of credit agreement analysis the authors elaborated a formula for calculation of monthly loan payments in occurrence of unfavourable period for the client of the bank.
As the result of qualitative analysis information about good practice of banks from other countries was acquired, for example, the data on Westpac Group (Australia), the Bank of America (the United States of America), the Bank of Lithuania (Lithuania) experience in the issues of responsible lending and its basic principles, and information included in mortgage loan agreements of four commercial banks of Latvia and their compliance to the laws and regulations of Latvia. The names of the banks were substituted with labels Bank 1, Bank 2, Bank 3 and Bank 4, because information included in credit agreements is not publicly available on home pages of banks. Stages for borrower evaluation were developed while reviewing credit applications.

4. RESEARCH DATA

To understand how other banks realized the responsible lending, the authors performed the analysis of the terms for responsible lending in Westpac Group (Australia), the Bank of America (United States of America) and the Bank of Lithuania (Lithuania):

1. Westpac Group:
1.1. Offers its clients products and services that they can afford. This principle includes conformity to definite local legislation, credit evaluation policy created by the bank; evaluation of credit application that includes information available in databases in order to evaluate a client's ability to repay; training of employees about criteria for granting loans; providing clients with information about possible loans so that they can evaluate their ability to settle the undertaken liabilities.
1.2. Product and service market is based on responsibility. The essence of terms – on the basis of principles of ethical and legal practice to inform clients about products and services provided by the bank; understand the demands and aims of the clients; estimate when the offered loan is not suitable for the client; client awareness of possible risks; client's financial status is evaluated in case of increasing credit card limit and loan; loan agreement monitoring process.
1.3. Solutions for clients who got under financial pressure. Process based on mutual understanding between bank – client including remissions for clients who get into difficulties; search for solutions, loan repayment holidays.
1.4. Level of financial education of interested parties. Based on public access to bank's money management, budget formation; finance education programme; availability of products and services; support local producers [21].
2. Bank of America has accepted National Association for the Advancement of Colored People (NAACP), that are based on responsible borrowing:
2.1. Loan terms will not be determined by a borrower's race, nationality, gender and other social principles.
2.2. Every borrower will have the option of selecting a loan product that is appropriate for his or her circumstances.
2.3. Institutions will seek to eliminate policies or practices that encourage biased and exploitive behaviours toward borrowers.
2.4. Borrowers will be approved only for loans they have a current ability to repay.
2.5. Each policy may be maintained and monitored for its racial impact.
2.6. All borrowers will have access to free information on existing loans.
2.7. Lenders will work with borrowers to prevent foreclosures.
2.8. Lending institutions will support and implement integration.
2.9. Workforce diversity in decision making [22].
3. Bank of Lithuania responsible lending is regulated by Resolution No 03-144 of 1 September 2011, with the following principles:
3.1. Before making lending decision credit institutions should perform consistent assessment of the borrower's ability to repay the credit also in case of violation of contractual obligations;
3.2. Information about premature credit repayment conditions should be included in credit agreement;
3.3. Prior to credit granting a qualitative and quantitative assessment of the property must be conducted;
3.4. Maximum loan-to-value ratio for credits granted for purchase of real property shall account for 85% of the market value or price of mortgage. The same principle refers also to construction and on the basis of actual volume of work done. There are also exceptional cases when loan-to-value ratio may be increased up to 10%, if this Project is supported by the State and conforms to the requirements established by the Law of the Republic of Lithuania on the State Support for Dwelling Acquisition or Rent and Renovation (Modernisation) of Blocks of Flats; credits supported by the State if the amount of granted credit does not exceed: for a single person – LTL 120 000 and for the family of two or more persons – LTL 240 000.

3.5. If the borrower wants to purchase more property, it should be subject to tighter limits.
3.6. For purchase of agricultural parcels loan-to-value ratio may not exceed 40% of acquisition price or market value of the parcel being purchased.
3.7. Loan-to-value ratio for credits secured by mortgage of different types of property shall be calculated separately per each property.
3.8. The average amounts of repayments of the principal and payments of interest shall not exceed 40% of income of both enterprises and households.
3.9. The credit granting decision shall be based on the history of sustainable income of minimum six months as well as current expenses.
3.10. If the credit currency differs from currency of the borrower's income, additionally the exchange rate fluctuation risk should be considered [23].
On the basis of the Association of Commercial Banks of Latvia and the Financial and Capital Market Commission (FCMC) data, in Figure 1 the authors have illustrated the total credit changes from 2006 to March 2012. According to FCMC data, in March 2012 38% of newly granted credits were issued for business development (non-financial and financial enterprises) and 62% to households, including residents and non-residents. What concerns the proportion of delayed credits, the proportion of credits delayed for more than 90 days in the total credit portfolio of the bank sector at the end of March reached 13.7% (without JSC "Parex banka") from which 16.5% in resident household credit portfolio but 13.4% in resident corporate client credit portfolio.

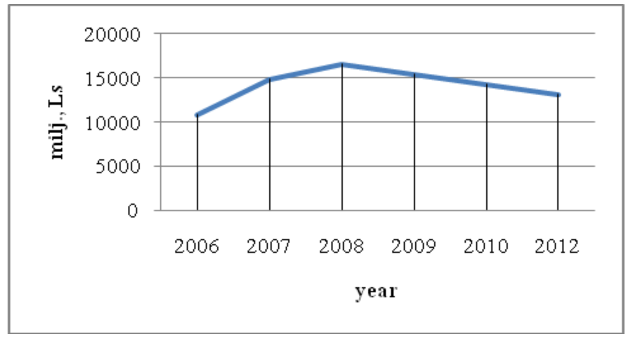

Fig.1 Changes in the volume of bank credits in Latvia

According to the information available on home pages of banks, there are 9 banks in Latvia that actively offer loans to individuals: Citadele, DnB, Nordea, PrivatBank, Rietumu, SEB, SMP Bank, Swedbank, Trasta komercbanka. Whereas passively, without providing detailed information about the volume of the offered loans, 3 more banks offer loans: ABLV, Baltic International Bank, GE Money Bank. Some banks, such as Latvian Business Bank, Expobank, Rigensis Bank do not offer loans at all, Norvikbank offers consumer lending, Latvian Mortgage and Land Bank performs the functions of the development bank, Investment Bank offers loans to enterprises for current asset increase, UniCredit Bank also offers loans to enterprises.
To evaluate the current situation in commercial banks in Latvia concerning credit volumes to individuals, which are backed by real estate, the authors summarized the information available on home pages of 9 banks and presented it in Table 1.

Table 1

Volume of loans in commercial banks of Latvia

Name of the bank	**Loan volume for purchasing housing**	**Loan volume for construction**	**Loan volume for purchasing land**
Citadele	Up to 70% of the market value of real estate (new mortgage)*, up to 90% of the market value (standard mortgage)	Up to 70% of the market value of real estate (new mortgage)*, up to 90% of the market value (standard mortgage)	Up to 70% of the market value of real estate (new mortgage)*, up to 90% of the market value (standard mortgage)
DnB	Up to 90% of the real estate value	Up to 75% of the value of house in future	No information
Nordea	Up to 90% of the market value of real estate	Up to 85% of the value of house in future	For purchase of land for building a house
PrivatBank	Up to 85% of the market value of real estate	Up to 85% of the market value of real estate	Up to 85% of the market value of real estate
Rietumu banka	70% of the market value of real estate	70% of the market value of real estate	50% of the market value of real estate
SEB	Up to 85% of the value of real estate	Up to 80% of the value of the building in future	No information
Swedbank	Up to 90% of the market value of real estate, 85% for standard projects	Up to 90% of the market value of real estate	No information
SMP Bank	Up to 90% of the market value of real estate	Up to 90% of the market value of real estate	No information
Trasta komercbanka	Up to 75% of the value of real estate	Up to 75% of the value of real estate	No information

*New mortgage credit provides possibility to extinguish credit liabilities at any moment of credit agreement, transferring the mortgaged real estate into possession of the bank.

Information included in Table 1 shows that the range of loan volume for purchase of housing and construction offered by banks varies between 70% and 90% of the market value of the property.

On the basis of Law on Protection of Consumer Rights, Cabinet Regulation No.1219 and the EU directives, the authors, from their own point of view, performed evaluation of conformity of points included in credit agreements of 4 leading banks, to these regulations and their comparison to credit agreements in force in 2012.

The analysis of credit agreements showed that banks in their credit agreements have included information that is based on existing legislation of Latvia and the EU concerning responsible lending and borrowing:

1. Creditor's identity;
2. Aims of credit use;
3. Duration of credit agreement;
4. Reference to currency, if the credit is taken in foreign currency, with explanation concerning the influence of credit in foreign currency on consumer;
5. Annual interest rate;
6. Sum and credit repayment instalments;
7. Frequency or exact dates of interest payment and other payments;
8. If the total amount of payment is not known, its calculation method is given;
9. List of payments related to credit;
10. Reference to the availability of advanced credit repayment and description of terms;
11. Reference to the necessity for property assessment and institutions that perform it;
12. Type of agreement security backing;
13. Liability for breach of terms of agreement.

Whereas the issue concerning "the reference to the amount of expenditures connected with credit refinancing" was indicated only by Bank 4 without mentioning the amount of bank's planned commission. Bank 1, Bank 2 and Bank 3 did not include information about credit refinancing and associated expenses in their agreement terms.

What concerns the volume of mortgage loan, Bank 1 foresaw the penalty not only for delayed payments but also for delayed submission of real estate insurance policy, with amount of 0.5% of the volume of gratuitous loan on the day of default on obligations (min LVL 100.00, max LVL 1,000.00), for not submitting specific information and/or documents to the bank - 0.05% (min LVL 5.00 and max LVL 500.00), as well as other defaults on obligations - 0.25% of volume of gratuitous loan but not less than LVL 100.00.

Bank 2, in turn, charges penalty of 0.16% per day from the sum of delayed credit payment for each delayed day for delayed credit payment, the same terms apply also to interest payments. The Bank also has special penalties for construction credits, if there is no compliance with laws and regulations concerning building permit, change of such personal data as name or surname of the borrower, as well as if the mortgaged real estate is not insured, the bank charges penalty of LVL 100.00. The Bank also intended to increase the interest rate from 0.25% to 1.0% if there have been delayed payments taking into account the number of days and frequency.

Bank 3 charges penalty for not submitting the required documents on time – LVL 2.00 per day.

Bank 4 charges penalty of LVL 25.00 for not submitting a new insurance policy and documents requested by bank on time, for change of residence or other personal identification data. The Bank charges additional penalty if the client repeatedly has not insured the mortgaged property – LVL 200.00, for additional terms in credit agreement 0.2% of the volume of gratuitous loan for each delayed day, but not more than 10% of the volume of gratuitous loan, as well as 10% from the amount of credit that has not been paid on 31st day, if the client has received preterm repayment request from bank.

For banks to become responsible for not only information that should be included in credit agreement but also for clients, they have to base their activities not only on financial but also social factors, by including environmental factors in the evaluation process of credit application, as it can be seen in Table 2.

Table 2

Stages of borrower's (private person's) credit evaluation when considering new credit application

Stage	**Activities to be implemented**
1st	1. Loan application; 2. Obtaining of general information about the client.
2nd	1. Evaluation of client's solvency taking into account financial factors; 2. Evaluation of offered security backing on the basis of environmental factors.
3rd	1. Draw up of the loan proposal
4th	1. Decision making
5th	1. Signing the agreement and monitoring

As it can be seen in Table 2, the most important stage in the evaluation of a private person's solvency is 2nd one, because not only financial threats but also environmental factors are at play. If, for example, a piece of land is used as a credit security backing, it is necessary to get information about whether there has been a factory on this land or some sort of pollution that is or could cause environmental pollution. When mortgaging a piece of land that is polluted, in the future it could cause additional expenditures for bank if it comes into possession of the land in case the client is not able to settle the debt. After stating nonconformity of one or the other factor, evaluation of solvency remains on the 2nd stage, which is followed by credit refusal.

On the basis of the performed analysis of the information included in bank loan agreements and imposed sanctions for breach of agreement terms, the authors elaborated a formula. The formula will allow calculating the amount of monthly credit payments and total expenses expected in case of any unfavourable scenario, for example, delayed credit payment, documents not submitted to the bank and other non-compliance to special terms.

$$c = \frac{D_1 + D_2 + D_3}{12} \Bigg/ \frac{\Pr(1+r)^n}{(1+r)^n - 1} \quad (1)$$

Where: c – proportion of total expenditure increase in monthly credit payment;

D_1 – penalty for delayed payments;

D_2 – penalty for delayed submission of insurance policy;

D_3 – other penalties;

r - the monthly interest rate, expressed as a decimal, not a percentage. Since the quoted yearly interest rate is not a compound rate, the monthly interest rate is simply the yearly interest rate divided by 12; dividing the monthly interest rate by 100 gives r, the monthly rate expressed as a decimal;

n - the number of monthly payments, called the loan's term;

P - the amount borrowed, known as the loan's principal.

CONCLUSIONS

In order to evaluate the overall situation in Latvia and the European Union the authors see it necessity for future research to perform analysis of laws and regulations of all European Union member states that concerns responsible lending.

During the research the authors faced a restriction that bank loan agreements are not publicly available and in order to preserve confidentiality of the banks that were willing to cooperate, the authors substituted the names with labels.

The new mortgage credit offered by commercial bank that provides opportunity to settle liabilities at any time of duration of the loan agreement, transferring the mortgaged real estate into possession of the bank, can promote irresponsible borrowing because the client will be able or willing at any time, for any reason to give away his mortgaged real estate, thus causing new fluctuations of the market and decrease in real estate prices, as well as additional expenses to the bank that will occur with properties in bank’s possession, similarly as it happened in the USA.

The authors consider that in Latvia regulations that strictly regulate mortgage lending issues should be introduced, because as seen considering the analysis of loan agreements, banks comply with the existing legislation. In addition to evaluation of existing financial factors evaluation of environmental factors should be performed.

Also the authors consider that in Latvia, similarly as in Lithuania, it is necessary to set equal terms of lending for all banks, that would include the maximal allowable sum from the market value of real estate or purchase sum, average proportion of credit and interest payment against income.

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